Board Policy 0116: Policy on Tax Exempt Bonds

I. Overview

Utilizing tax exempt bonding provides The Claremont Colleges, Inc. (TCC), the charitable organization, with a low cost long-term solution for financing projects. Because public bonding is exempt from federal taxation, TCC is able to obtain much more favorable lending interest rates than with a conventional loan. Tax-exempt financing is a well-established practice among institutions of higher learning as an optimal solution to funding requirements.

II. Authority

Bonds themselves are not issued by the entity seeking the financing. Instead, they are issued by the state or federal government, who in turn lends the proceeds to the borrowing party. The primary requirement placed on a party seeking tax-exempt bonding is that it must be a "501(c)(3) corporation." A 501(c)(3) corporation will have received a determination letter from the Internal Revenue Service indicating that it qualifies under that code section.

III. Policy Objective and Purpose

This policy exists to outline the guidelines for proper Tax-Exempt Bond usage in order to ensure that the funding is properly protected and utilized. The Tax-Exempt status of these bonds is protected for the life of the bond; however failure to comply with federal restrictions can cause a loss of this protection. The restrictions primarily pertain to issues of arbitrage, timing, and the usage of bond proceeds. This policy exists to guide TCC through the proper procedures to maintain the tax exempt status of its bonds.

IV. Intended Recipients

This policy letter is applicable for all TCC staff members who are involved in any respect to the Tax-Exempt bonding process. This includes:

- Issuance and creation of such bonds
- Usage of bond proceeds and the requisite usage timing
- Investment of bond funds and arbitrage processes
- Property management financed by tax-exempt bonds, such as leases and service agreements
- Anyone responsible for the creation and retention of documentation relating to receipts, return filings, proceeds, arbitrage, and private usage
- Personnel responsible for recording financial transactions connected to the bonds

V. Definitions

The following terms used in the policy are defined below and their subsequent usage in the document is to reflect only the meanings and context explicitly articulated in their contained definition.

- **<u>Non-Governmental Person</u> –** not belonging to or associated with local, state, or federal government.
- **<u>Private business use</u>** – IRC section 141(b)(6): Use, directly or indirectly, in a trade or business carried on by any organization or entity other than a governmental unit, not including use as a member of the general public. Examples of private business use include 1) unrelated trade or business use and 2) private use by parties other than the charitable organization of the tax-exempt debt-financed property.

  Generally, no more than 5% of the proceeds of tax-exempt bonds may be used for private business use of the tax-exempt financed property. For purposes of the 5% limit on private business use, bond issuance costs financed with bond proceeds (approximately 2%) are included as private business use, so typically private use is limited to 3%.

  Private business use is determined over the life of the bond and is calculated annually.

- **<u>Arbitrage</u>**–IRC section 148 - Investment earnings on bond proceeds in excess of the bond interest paid to bondholders. Generally, materially higher means one-eighth of one percentage point.

VI. Policy

1. Responsibilities of Management:

TCC's chief financial officer (CFO) is tasked with ensuring total compliance with all applicable IRS laws and regulations concerning Private Business Use (PBU). As a required portion of all new building projects, an analysis must be done to determine if debt financing is a required component of the overall funding of the project being assessed. If it is determined that debt financing is required, approval for the project must include an analysis to determine if Private Business Usage will be incurred with the current plan. If the total level of PBU exceeds the IRS approved limits, then the building plan will either be revised, or the CFO may need to turn to taxable debt financing, despite the higher borrowing cost.

The CFO, Director of Business Affairs, Controller and Assistant Controller are tasked with maintaining the bond for the duration of its lifespan. The following tasks will be performed at least annually:

A. Review of any contracts, prior to signing, renewal, or significant modification, related to the bond funded project with bond counsel to determine if there is PBU. If it is determined that PBU will result from the contract, management will determine if 1) the contract needs to be changed to meet safe harbor, 2) the contract is allowed because the total PBU is within acceptable limits, or 3) the contract needs to be cancelled.
B. Ensure that appropriate rebate is calculated and, if required, remitted to the U.S. Government.
C. Fulfill debt compliance reporting (Continuing Disclosure Agreement) per the Tax Agreement of each outstanding bond issue.
D. Maintain record retention related to all bonds outstanding (and those refinanced by outstanding issues).
E. Allocation of PBU will be calculated by bond issue and based on the square footage of the debt financed project, time of use of the debt financed facilities, or other reasonable method for calculation or allocation of PBU.

F. If the potential to fail to comply with post issuance compliance activities is identified, the CFO will seek the advice of bond counsel in order to assess the need to take remedial actions described under section 1.141-12 of the Income Tax Regulations or enter into a closing agreement under the Tax-Exempt Bonds Voluntary Closing Agreement Program described in Notice 2008-31. Self-remediation may be done by establishing an irrevocable defeasance escrow or by redeeming the nonqualified bond. If no self-remediation actions are available, an attempt to negotiate a closing agreement with the IRS under the Voluntary Closing Agreement Program will be made.

2. Private Business Use:

A. Most Private Business Use (PBU) in a tax-exempt financed facility arises from the following types of arrangements:

1. **Ownership:** A sale or transfer of ownership to a Non-Governmental Person of tax-exempt financed property. Ownership is determined under federal income tax principles.
2. **Leases:** Any arrangement that is properly characterized for federal income tax purposes as a lease to a Non-Governmental Person.
3. **Management Contracts:** A management contract is any arrangement whereby a Non-Governmental Person actively manages the operations of a facility. Management contracts include, for example, contracts for dining services, facility management, or vivarium services (management of an animal facility).
4. **Research Agreements:** Any non-government sponsored research agreement. Rules regarding sponsored research are set forth in the IRS Revenue Procedure 2007-47. Qualifying research agreements must be for "basic research" and the rights of the sponsor to the results of the research must comply with stated rules.
5. **Cost of Issuance:** Costs incurred in connection with issuing the bonds, such as underwriter's discount or fees, fees of bond counsel and other lawyers and consultants, rating agency fees, trustee's fees and the like, may be included in the bond issue, subject to a cap of 2% of the bond issue.
6. **Other Actual or Beneficial Use:** Any other arrangement that conveys special legal entitlements to a Non-Governmental Person for beneficial use of tax-exempt financed property, such as an arrangement that conveys priority rights to use a tax-exempt financed facility, will result in PBU. Examples of such "special legal entitlements" include summer camps having the exclusive right to use an athletic facility, specially designed courses open only to one company, or use of a parking garage for a private event.

B. **Exceptions**: There are some exceptions under which PBU will not impact the tax exempt status of the bond issue.

1. General public use
2. Short-term use: The activity is irregular and infrequent
3. Incidental use: The activity does not take place in a space that is held exclusively for that purpose.
4. Safe Harbor: However, there are exceptions for certain contracts meeting the Safe Harbors set forth in Rev. Proc. 97-13. In order to meet the Safe Harbors, the contract must provide for reasonable compensation to the Non-Governmental Person for services rendered with no compensation based in whole or in part on a share of net profits. Arrangements that generally are not

treated as net profit arrangements and therefore satisfy the Safe Harbor requirements include contracts for a percentage of gross revenues or expenses (but not both), or a per person or per unit fee. Management contracts must be analyzed in advance by TCC's Attorney for their impact on tax- exempt financed facilities.

3. Document Retention

The IRS requires that all records related to the sale, expenditures and use of bond- funded facilities be retained for three years beyond the final maturity date. This would include at a minimum the following records:

- Basic records relating to the bond transaction (including the trust indenture, loan agreements, and bond counsel opinion-bond sale transcript);
- Documentation evidencing expenditure of bond proceeds (both internal and external);
- Documentation evidencing use of bond-financed property by public and private sources (i.e., copies of management contracts and research agreements);
- Documentation evidencing all sources of payment or security for the bonds; and
- Documentation pertaining to any investment of bond proceeds (including the purchase and sale of securities, SLGs subscriptions, yield calculations for each class of investments, actual investment income received the investment of proceeds, guaranteed investment contracts, and rebate calculations).

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